Bad Deal

FDR's public works only exacerbated the Depression.

By Sheldon Richman

NEVER HAS THE PHRASE "the worst economic crisis since the Great Depression" been uttered so often. Reporters and commentators routinely discuss our current financial woes as though it were 1930 again. Pundits and even economists urge President-elect Barack Obama to launch a "new New Deal" as soon as he takes office. Thus it might be useful to revisit the original Great Depression and New Deal to see what actually happened and what lessons we might draw for the present crisis.

The first thing to understand is that these events did not occur in an environment of laissez faire. Contrary to popular accounts, government intervention in the U.S. economy did not begin in 1933 with the inauguration of Franklin Roosevelt. Before that America was no land of unregulated markets. Far from it. Government had intervened in the economy from the very beginning: the first economic act of the first Congress—on July 4, 1789—was a comprehensive protective tariff. Before long, the banking industry, in particular, faced detailed federal and state regulation. Significantly, branch and interstate banking were forbidden. Free-market banking did not exist, and the gold standard was limited.

In 1913, the political class, which included big bankers, decided that a more systematic regulatory regime was needed to keep the economy on an even keel. Hence, the Federal Reserve System—in essence a government-sponsored banking cartel—was born.

The chronology is important because the worst U.S. depression occurred 15 years after the Fed opened. Someone ignorant of history and economics might guess the Fed was set up to prevent a repeat of the Great Depression, but he would be wrong.

As for the events of 1929 and onward, we may start with a remark by Fed Chairman Ben Bernanke. Speaking at a celebration of Milton Friedman's 90th birthday, Bernanke, at the time a member—but not yet chairman—of the Fed's Board of Governors, said, "I would like to say to Milton and Anna [Schwartz, coauthor with Friedman of *A Monetary History of the United States*]: 'Regarding the Great Depression, you're right. We did it. We're very sorry.'"

How did they do it? According to economist Murray Rothbard's history of the period, *America's Great Depression*, the 1920s were marred by the Federal Reserve's inflation of credit in 1921-22, 1924 (a presidential election year), and 1927. The Fed's policy, backed by the pro-business Republican administration of Calvin Coolidge and Treasury Secretary Andrew Mellon, began as a way to end the 1920-21 depression. Other motives were at work, however, such as facilitating exports through easy loans to foreign governments and helping Great Britain cope with its wartime inflation by re-establishing its prewar gold-to-sterling ratio.

According to Rothbard, the money supply grew by nearly 62 percent, or 7.7 percent a year on average. "The inflation of the 1920s was actually over by the end of 1928. ... And therefore, from that time onward, a depression to adjust the economy was inevitable," he added.

Why inevitable? To answer this we must understand the role of interest rates in a free market. Other things being equal, people prefer goods in the present to goods in the future. If they are to defer consumption, they typically must be compensated. That rate of compensation is an interest rate. This "time preference" can vary in intensity. One person might be willing to lend money at 5 percent, while another might insist on 10 percent. The market interest rate emerges from competition among lenders and borrowers. Changes in the rate, absent government intervention, signal real changes in people's time preferences. Interest rates rise when people reduce savings and consume more; interest rates fall when people decide to defer consumption and save more.

These signals guide entrepreneurs in their decisions about how to invest scarce resources in a structure of production with many stages and time periods. High rates signal that scarce capital should go toward consumer goods and producer goods that are close to the consumer-goods stage. Low rates signal more abundant savings and deferred consumption, telling producers that they can invest in longer-term projects at stages of production further removed from the consumer-goods stage.

It is this critical time-signaling function that is damaged when the government's central bank expands the money

supply. The Fed inflated in the 1920s precisely to lower the interest rate below the free-market level. Since the signals created by the Fed were false in the sense that they were not aligned with consumers' true time preferences, producers and investors behaved differently than they would have in a free market, that is, in ways they would regard as erroneous later. That behavior changed relative prices and distorted the structure of production. Thus the 1920s boom—built as it was on false expectations induced by the Fed's easy credit—was unsustainable. An end to the inflation would reveal malinvestment and necessitate correction—the depression phase of the government-created business cycle.

With the Fed's inflation over by the end of 1928, the bust was just a matter of time. The stock market crash in October 1929 left banks with unpaid loans, and their shaky condition eroded confidence and set off bank runs. Companies failed, and unemployment rose. All of this was the market's way of reasserting itself and attempting to correct for past errors created by the government's signal-tampering.

This might have been a one- or two-year depression, like those of the past, but the Fed's blunders did not end with the inflation. Once stock prices plummeted and banks lost reserves to worried depositors, the money supply contracted, something the Fed permitted and even facilitated. The central bank had been established as lender of last resort to the banking system, obviating the market's own solution to illiquidity. But the central bank abdicated its role at a critical time. The Fed's deflation was fatal to the economy. The Austrian economist Ludwig von Mises analogized about deflation in 1938, "If a man has been hurt by being run over by an automobile, it is no remedy to let the car go back over him in the opposition [sic] direction." Friedman and Schwartz showed that the money supply shrank 27 percent from 1929 to 1933. With banks failing, people held on to their money and reduced consumption, which in turn left businesses without customers. So they laid off workers, who cut back on consumption. Hence the eventual secondary depression.

The government made things worse by aggressively interfering with the market correction. Contrary to common misconception, interference did not begin with Roosevelt's New Deal but rather with Herbert Hoover, who took office in March 1929. As one historian put it, Hoover, an engineer by profession and part of the Republican Party's progressive wing, was not the last of the old presidents but the first of the new. In previous depressions, the federal government typically cut spending and taxes and let the market liquidate bad investments. As a result, the depressions were relatively brief. This time around Hoover moved quickly to raise government spending and taxes of all kinds (the top marginal income-tax rate went from 24 to 63 percent); subsidize banks, railroads, industries, homeowners with mortgages, local governments, and farmers; and sign the infamous Smoot-Hawley Tariff. Even with the tax increases, the budget deficit ballooned to record levels. Hoover urged the nation's governors to increase public-works spending substantially and had the federal government join the effort. He favored new rounds of inflation, but the Fed's efforts were offset by factors beyond its control. Egregiously, Hoover personally pressured major corporations not to cut wages. (As commerce secretary, he had long been an advocate of government-business-labor "partnership," i.e., cartelization.) When wages are rigid while all other prices are falling, unemployment goes up.

The result of Hoover's program? Unemployment went from 3.2 percent in 1929 to over 25 percent in 1933. It remained in double digits until 1941, a year after the military draft started. GNP shrank 44 percent from 1929 to 1932.

"[W]e might have done nothing," Hoover said. "That would have been utter ruin. Instead we met the situation with proposals to private business and to Congress of the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic." This was the "Hoover New Deal," as economist Benjamin Anderson called it at the time. If interventionist economic theory were correct, Hoover's program should have been a smashing success and he should have been reelected handily in 1932. But the economy deteriorated, and Roosevelt ignominiously defeated Hoover.

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FDR ran on a program of balanced budgets, reduced government spending, and sound money, but once in office he raised taxes and spending to new heights and confiscated the people's gold. His list of New Deal programs is familiar, beginning with the fascistic National Recovery Administration, which cartelized industry; the Agricultural Adjustment Administra-

tion, which brought central planning to farming; banking and securities regulation; and the make-work Civilian Conservation Corps and Works Progress Administration. The massive public-works spending helped Roosevelt politically, but did little to employ those most desperately in need. Journalist Walter Lippmann called the WPA "worse than a failure." After the Supreme Court declared the NRA and AAA unconstitutional in 1935 and 1936, Roosevelt began the Second New Deal, which included Social Security, the National Labor Relations Act, and other impediments to free and competitive economic activity.

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Yet with all this government activism, the U.S. economy, despite halting attempts at recovery, could not shake the Depression. In 1937 and 1938, the financial system went into an unprecedented secondary depression, with a new stock-market crash and unemployment climbing back to over 20 percent. Jim Powell notes in *FDR's Folly* that the New Deal further eroded the banking system; raised taxes; made hiring workers, particularly unskilled blacks, prohibitively expensive; increased the price of most goods, including food; and discouraged investment. This is hardly the New Deal we're taught in school. As historian David Kennedy put it, "Whatever it was, [the New Deal] was not a recovery program, or at any rate not an effective one."

Roosevelt did not come into office with a detailed program based on a firm ideological foundation. Rather, he saw himself as a pragmatist ready to try anything, an approach that engendered stultifying uncertainty. First, he mandated anticompetitive cartels; then he brought antitrust prosecutions against firms for monopolistic activity. Businesses were afraid to make long-term investment plans under such circumstances. Economic historian Robert Higgs writes in *Depression, War, and Cold War*, "Taken together, the many menacing New Deal measures, especially those from 1935 onward, gave business people and investors good reason to fear that the market economy might not survive in anything like its traditional form and that even more drastic developments, perhaps even some kind of collectivist dictatorship, could not be ruled out entirely."

The New Deal did not, therefore, end the Depression. Yet as Higgs shows, neither did World War II. If by "depression" we mean falling living standards as a result of economic inactivity, we can hardly count the war years, with their rationing and shortages of consumer goods, as years of prosperity. The draft is a bogus way to reduce unemployment. The Depression ended after the war, when labor and industry could turn to satisfying consumers, not government.

What can we learn from all this? That money is too important to be left to the state. One way or another, government mismanagement of the monetary system wrecked the U.S. economy. It's happening again now. The only permanent way to avoid a repetition is to place the system where it belongs: in the free market.

Second, efforts to prevent liquidation of malinvestment caused by inflation bankrupt companies and only prolong economic agony. Bailouts are counterproductive. Assets must be revalued and rearranged in the light of reality.

Third, government stimulus spending, borrowing, taxation, and public works commandeer scarce private resources and prevent entrepreneurs from shifting them to investments aligned with consumer, not political, preferences. As Price Fishback of the University of Arizona points out, even FDR didn't try to stimulate the economy with extraordinary budget deficits, something for which Keynes criticized him.

Fourth, individual liberty is the first casualty when bureaucracy expands to manage the economy.

President-elect Obama would do well to take note, but we hardly have grounds for optimism. Obama has declared his intention to spend, New Deal-style, hundreds of billions of dollars—perhaps a trillion—to rebuild infrastructure, modernize schools, retrofit public buildings for energy efficiency, and expand the broadband network. No matter how meritorious these projects, they do not constitute a genuine recovery program. Government cannot escape the fact that it cannot create wealth. It can only transfer wealth from the private sector or create the illusion of wealth through inflation. Jobs created under inherently politicized programs will displace jobs the private sector would create if the burden of government were lifted and investor confidence restored.

It's about time we learned something from the New Deal. ■

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